STATE OF MAINE
PUBLIC UTILITIES COMMISSION

March 19, 2003

Docket No. 99-851

PUBLIC UTILITIES COMMISSION
Investigation into Verizon Maine's
Alternative Form of Regulation

NOTICE OF FURTHER
PROCEEDINGS FOLLOWING
REMAND

WELCH, Chairman; NUGENT and DIAMOND, Commissioners

I. SUMMARY

In this Notice, we provide an opportunity for parties to comment on issues that we must address following the vacation and remand, by the Law Court, of the Commission's final Order (June 25, 2001)[1] ("Order" or *2001 AFOR Order)* in this proceeding. There are three major subject areas: the increase of $1.78 to rates for local exchange service; what should happen in the interim, between now and when we complete this proceeding; and how to address the finding required by 35-A M.R.S.A. § 9103(1).

II. BACKGROUND

On appeal by the Public Advocate of the Commission's Order, the Maine Supreme Judicial Court, sitting as the Law Court, vacated and remanded the Commission's Order in this proceeding. *Office of the Public Advocate v. Public Utilities Commission and Verizon New England, Inc*., 2003 ME 23, ___A.2d___ (*OPA v. PUC/Verizon*).

The Court vacated the Order because it ruled that the Commission did not adequately ensure, as required by 35-A M.R.S.A. § 9103(1), that "ratepayers as a whole, and residential and small business ratepayers in particular, may not be required to pay more for local telephone services as a result of the implementation of an alternative form of regulation than they would under traditional rate-base or rate-of-return regulation." The Court also ruled that the Commission "acted within its discretion in allowing Verizon to increase its basic service rates." *Id.* at ¶1.

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[1] The Commission also issued an Order Granting Requests for Reconsideration; Order Granting and Denying Modifications on October 12, 2001. That order addressed some of the same arguments the Public Advocate made earlier to the Commission and to the Law Court on appeal. Although the Court did not expressly vacate this Order, we consider that it is no longer effective.

III. BASIC RATE INCREASE TO OFFSET LOST ACCESS REVENUE

We request comment on whether we should allow Verizon-Maine to continue, without interruption, to charge the rates for local exchange service that are now in its rate schedule, i.e., the rates it implemented following the Order in this case. Those rates include the increase to all local rates of $1.78 ordered in the *2001 AFOR Order* to offset the access revenue loss that occurred in May of 2001 when Verizon complied with the requirement of 35-A M.R.S.A. § 7101-B. We have tentatively concluded that we should leave the current local rate (including the $1.78 increase) in place.

The Law Court explicitly ruled that Commission "acted within its discretion in allowing Verizon to increase its basic service rates," relying on past case law. Nevertheless, it also stated that "but because we agree, in part, with the Public Advocate that the Commission failed to fully comply with section 9103(1), we vacate and remand to the Commission for further proceedings."

The Court vacated the entire *2001 AFOR Order* because of deficiencies in the Commission's finding that local ratepayers would not pay more under the AFOR than they would under rate of return regulation (ROR). Nevertheless, at the same time, it held that the increase to local rates to offset access revenue losses was within the Commission's discretion.

The Commission argued to the Court that the access rate reduction and the associated local rate increase were events that were outside of, and unrelated to, the AFOR. The Court did not expressly accept or reject that argument. Nevertheless, in ruling that the Commission acted within its discretion, the Court relied on its decision in *New England Telephone and Telegraph Co. d/b/a NYNEX v. Public Utilities Commission,* 1997 ME 222, 705 A.2d 706, in which the Commission, pursuant to a provision in Chapter 280, § 8, required local exchange carriers to reduce access rates by 20 percent. The Chapter 280 requirement was unrelated to any other proceeding, including the existing AFOR.

The Commission also opened another proceeding in 1997 that was independent from any other proceeding, including the existing AFOR, to address the need, in 1999, for Verizon to comply with the access parity statute, 35-A M.R.S.A. § 7101-B.[2] Pursuant to that proceeding, the Commission accepted a Stipulation, which the Public Advocate joined, that resulted in a $3.50 increase in local rates to offset access revenue losses.[3]

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[2] *Maine Public Utilities Commission: Proposed Amendment to Chapter 280 to Achieve Parity With Interstate Access Rates by May 30, 1999*, Docket No. 97-319, Notice of Rulemaking; Notice of Inquiry (June 10, 1997).

[3] The result was eventually tied into the AFOR because it was necessary, in effect, to waive one of the pricing rules of the AFOR, which prohibited increases to local rates unless inflation exceeded productivity.

It thus appears that the Law Court has concluded that the Commission may consider the question of access revenue losses outside the context of a proceeding that also considers the form of an AFOR. The Commission has done so twice; the Law Court upheld its decision to do so on one of those occasions. The consideration of access losses is not necessarily integral to an AFOR.[4] It follows that we do not have to make the finding under section 9103(1) that local ratepayers are paying no more for local service under an AFOR than they would under ROR, in order to impose the local rate increase to offset access revenue losses.

In one respect the consideration and decision to increases local rates to offset access revenue losses was tied to a decision in the AFOR case: our refusal to allow Verizon to increase local rates even further to offset expected losses in retail toll revenue. (That refusal was also tied to a decision that the likely retail toll loss was a substitute for a formal productivity factor.) The *2001 AFOR Order* indicates that the two decisions were, at least in part, an attempt to achieve a balanced result that accommodated conflicting interests.[5] We do not propose, either temporarily or permanently, to change our decision in the *2001 AFOR Order* that Verizon will not be allowed a local rate increase to offset retail toll losses. Because of the balancing discussed above, if we were to rule that Verizon cannot maintain the $1.78 increase to local rates to offset access loss, it is possible that we would have to reconsider the retail toll revenue loss decision as well.[6]

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[4] The Order (October 27, 2000) that extended the original AFOR for six months noted that the timing of the access reduction required by law and the expected conclusion of the AFOR was coincidental. That the matters might be separate is indicated by the fact that, at one point in this proceeding, the Public Advocate objected to the inclusion of the issue in the AFOR cases, arguing that it had not received adequate notice that the access revenue loss would be considered.

[5] We also stated substantive reasons for the different treatment of the two revenue losses. Although there is a clear relationship between the two, our primary basis for distinguishing them was that Verizon had substantially more control over its retail toll rates and revenues than it did over access revenues.

[6] More broadly, the $1.78 increase would not necessarily survive as such if we were to conclude that a proceeding to determine Verizon's current revenue requirements is necessary or desirable. In that instance, the amount of the access revenues that we expect the company to receive would simply be one element in making the larger determination of the Company's revenue requirement and rates, whether actual or for the purpose of the Section 9103(1) determination. In such a proceeding, the 2001 access loss would not be an issue. Any rate proceeding would be forward-looking, and would take into account present (e.g., 2002 test year) access revenues (which would automatically reflect the 2001 access rate reduction) and forward-looking adjustments, if any.

We request comments on our tentative conclusion, and the analysis above, that we should retain the $1.78 increase to local rates independently of the determination we must make under 35-A M.R.S.A. § 9103(1). A party may, of course, argue that the $1.78 increase should remain in effect on an interim basis, leaving the decision of whether the increase would remain in effect permanently until after we had made (or concluded that we could not make) the Section 9103(1) finding.

IV. INTERIM REGULATION

The Law Court "vacated" the AFOR order. As noted above, we believe the Court vacated the entire Order, including portions that were not appealed (e.g., the Service Quality Index (SQI) and portions (e.g., local rate increase) that are arguably not integral to the AFOR. The Court's logic is, presumably, that, in the absence of the findings required by Section 9103, it is not possible to implement an AFOR.

We tentatively conclude that Verizon has not "reverted" to the previously existing AFOR (whether called the "old" AFOR or "phase one" of an ongoing AFOR). Our Order of October 27, 2000 extended the 1995-2000 AFOR to May 29, 2001. In the absence of an AFOR ordered pursuant to 35-A M.R.S.A. §§ 9101-9105, a telephone utility is subject to "normal" regulation pursuant to 35-A M.R.S.A. §§ 301-312 and §§ 1302-14. If any party disagrees with this analysis, we request that it address this matter in its comments.

It is therefore necessary to address the form of regulation of Verizon Maine between now and when we can complete proceedings to address the requirement of 35-A M.R.S.A. § 9103(1). Until we complete this proceeding, we propose to continue the pricing rules and other features of the vacated AFOR. These include:

- A cap on local rates, subject to certain possible increases, external to the AFOR, for changes to basic service calling areas (BSCAs), for the possible elimination of rate groups[7], and for further required access rate reductions,[8]

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[7] It is likely that any elimination of rate groups would be done on a revenue-neutral basis, so that rates for rate groups with smaller calling areas would increase and those for rate groups with larger calling areas would decrease.

[8] We discussed this possibility in the *2001 AFOR Order* at 18-19. We noted that future expected access rate decreases are likely to be much smaller than the 2001 decrease, that "their size may raise questions about whether they should be considered exogenous and subject to a pass-through in rates," and that Verizon was free "to decide whether it should seek to justify, under the rules of the revised AFOR, any changes to basic rates based on the 2003 access reductions." Because of possible changes to

? Caps on operator services and directory assistance rates,

? Pricing flexibility for retail toll,

? Pricing flexibility for optional services,

? The Service Quality Index, and

? The ability to change rates for exogenous changes.

Litigation over the form of regulation during the interim period of this proceeding does not appear to be a productive use of time and will inevitably make that interim period longer. We note that, on appeal, neither the Public Advocate nor Verizon claimed that any of the specific features listed above should be reversed for any reasons inherent in the features themselves or the Commission's bases for adopting them. The Public Advocate argued on appeal only that the Commission should have conducted a rate case in order to be able to meet the requirement of Section 9103(1). Verizon did not cross appeal.

We request the parties to comment on our proposal to order that the pricing rules, SQI, and other features ordered in the *2001 AFOR Order* be put into effect during the interim period that runs from the date of the Court's decision until we order a permanent form of regulation. Our proposal is to retain the *status quo*.

The position a party takes concerning interim regulation will not prejudice it for any position it may take concerning permanent regulation issues.

V. ADDRESSING THE SECTION 9103(1) FINDING

A. What Information Does the Commission Need to Address This Question?

The portions of 35-A M.R.S.A. § 9103 that are relevant to this remanded proceeding state:

> Unless the commission specifically finds that the following objectives are not in the best interests of ratepayers, the commission shall ensure that any alternative form of regulation it adopts under section 9102 is consistent with the following objectives.

35-A M.R.S.A. § 7101-B, it is possible that Verizon will not be required to decrease its access rates on May 30, 2003.

> **1. Alternative regulation; period.** For the period of the alternative form of regulation, which may not be less than 5 years nor exceed 10 years without affirmative reauthorization by the commission, ratepayers as a whole, and residential and small business ratepayers in particular, may not be required to pay more for local telephone services as a result of the implementation of an alternative form of regulation than they would under traditional rate-base or rate-of-return regulation.

The Law Court held that the Commission, in the *2001 AFOR Order*, did not provide an adequate basis for its finding under subsection 1. The Court stated:

> The ensurance that has to be made pursuant to section 9103(1) is more than a *probability* that the AFOR will not require ratepayers to pay more than under a ROR system. [Legislative history omitted.] The [original proposed] language, however, was amended prior to enactment to require that the objective be ensured with more certainty than a likelihood. *See* P.L. 1993, ch. 638 § 2. The amendment required the Commission to ensure that ratepayers would not pay more for basic service than they would otherwise pay under a ROR system. *Id*. …
>
> Ensuring the objectives with the certainty required by section 9103 is no easy task. …
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> … Ratemaking is a forward-looking exercise. The Commission is required to ensure that, over the next five years, rates under the proposed AFOR will be no greater than what rates would be under a *return* to a system of ROR regulation. The Commission must, pursuant to section 9103(1), determine whether returning to a ROR system *now* would mean that ratepayers would pay rates no lower than they will under the new AFOR over the next five years.[9]
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> In making the ensurance that the rates under the AFOR would be no higher than they would be on a return to ROR regulation, the Commission notes and relies on what it considers to be the many advantages of incentive based regulation over rate-of-return regulation. Those advantages reflected in the experience of the first AFOR regulating Verizon, and the benefits of incentive based regulation in other jurisdictions, are legitimate factors for the Commission to consider. A fair reading of section 9103(1), however, contemplates that the

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[9] [Court footnote] The parties disagree about whether the AFOR created by the Order on appeal adopts a new AFOR or merely extends the old. We need not make this determination in order to resolve the question presented in this appeal. In light of the two significant events that took place during the original AFOR, i.e., the merger with Bel lAtlantic and the enactment of the Access Parity Statute, along with the modifications made to the original AFOR plan, the Commission is required to comply with section 9103 regardless of whether the plan implemented over the next five years is a new plan or merely an extension of the original plan.

> Commission will base the rate comparison determination on more than a general comparison of such systems *alone*. To comply with the letter and spirit of section 9103(1), some reliable estimate, based on objective data, of what local rates would be for Verizon in the 2001-2006 period of time under a ROR system is essential. The Commission should consider objective data pertaining to Verizon's financial status, such as the effect of the merger with Bell Atlantic, in order to make an adequate comparison of what rates would be under the two different systems of regulation, a comparison that would be subject to meaningful appellate review. The statute does not allow the Commission to choose incentive based regulation of telephone utilities without making a specific determination based on at least some comparison of local rates estimates under the different systems of regulation.
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> The Commission has great expertise and broad discretion. It has many ways of gathering information and applying its expertise to analyze and assess information that it gathers in complying with the objectives of section 9103 that do not necessarily require a *full* rate-of-return inquiry.

OPA v. PUC/Verizon ¶¶ 24-28.

The Court's opinion, and our own consideration of the opinion, generate several questions:

1. The Court interprets the 35-A M.R.S.A. § 9103(1) as requiring the Commission to make findings about two alternative futures. If the Commission attempts to make the finding (a/k/a ensurance or assurance) required by 35-A M.R.S.A. § 9103(1), what information does the Commission need to make those findings?

2. Over what time period should the Commission make the finding? 35-A M.R.S.A. § 9103(1) states that the assurance required by that subsection shall be "[f]or the period of the [AFOR], which may not be less than 5 years nor exceed 10 years without affirmative reauthorization by the Commission… ." Accordingly, it may be necessary for the Commission to determine the length of the future AFOR (if it is ordered) in order to determine the time span over which it must make the Section 9103(1) finding. If the Commission orders an AFOR, should it be effective until May 31, 2006 (five years from the date the vacated AFOR was ordered), five years from the date of any order issued in this remanded proceeding, or some other period of time?

3. Is information about costs and earnings (revenue requirement information) useful in making the determination required by Section 9103(1)? Does it provide information only about one of the two questions (ROR regulation), and for that, only for the very earliest portion of an AFOR?[10] What useful information does revenue requirement information provide for predicting local rates under an AFOR?

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[10] An attrition study, common in revenue requirement proceedings, normally attempts to predict revenue and cost changes that might occur during the "rate effective

4. Even if revenue requirement information provides some help in determining future rates under ROR, does it tell us much about rates for local service, given that local rates are a product not only of a revenue requirement finding, but of rate design as well. Should we consider whether, in effect, to modify the finding requirement in Section 9103(1) so that we must find that "ratepayers as a whole, and residential and small business ratepayers in particular, may not be required to pay more for local *and long distance* telephone service*s combined* as a result of the implementation of an alternative form of regulation than they would under traditional rate-base or rate-of-return regulation." (Italics show the modifications to the "objective.") To make what amounts to a modification of the "objective" in subsection 1, the Commission would find, pursuant to the introductory sentence in Section 9103, that the "local rate" objective was not one that was "in the best interests of ratepayers," and instead require, as a matter of Commission decisional law, that it ensure the modified objective.[11]

Would such an altered finding be easier to make because it could ignore rate design considerations? Or would rate design under both alternative regulatory courses be so similar as to make its elimination as a factor meaningless? Even if altering the finding would make the determination of rates under ROR easier, does it help in any way to make the determination about rates under an AFOR?

In any event, would the altered finding discussed above constitute a better public policy than the finding presently required by Section 9103(1)?

5. Should the Commission ignore any information (possibly including revenue requirement information) that would apply equally under both alternative futures? For example, if a revenue requirement determination served as the starting point for both ROR and an AFOR, would that information be useful in making the comparison between the two courses? Or could the Commission simply assume the same starting point for both courses? Similarly, if an increase in rates to offset a BSCA or an access revenue loss would occur under both alternative courses, does knowing their size in advance provide any useful information? Would information about the amount of savings that resulted from the Bell Atlantic merger fall into the category of information that would apply equally under either regulatory course, or should the Commission determine whether savings In Maine achieved as a result of the merger would be greater under an AFOR due to the strength of the AFOR incentives?

Is it possible that we should apply some of this information unequally, e.g., to predicted rates under ROR, but not to predicted rates under an AFOR, on the ground that actually establishing a revised "starting point" under an AFOR would diminish

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period," defined for the purpose of such studies as the first year during which rates will be in effect.

[11] The *1995 AFOR Order* in Docket No. 94-123 found that *both* local and retail toll ratepayers would have lower rates under the AFOR than under ROR regulation.

incentives too severely?[12] Is expected retail toll revenue loss a category that should be applied unequally, if, under an AFOR that was the same as the vacated AFOR, Verizon would be required to absorb toll revenue losses, whereas, under ROR, Verizon would be permitted to file a rate case as often as once a year and seek to make up lost toll revenue in other rates?

6. In making the finding about rates under the AFOR that the Court rejected, we relied heavily on incentive regulation theory. That theory is summarized at ¶¶ 2 – 5 of the Court's opinion. What types of other information (aside from incentive theory and revenue requirement information, discussed above) will aid the Commission in making a finding about rates under an AFOR or a comparison between rates under an AFOR and ROR?

7. Is there economic or regulatory literature that provides historical comparisons of local (or overall) rates under both forms of regulation? If so, please provide citations to that literature. Can the Commission rely on such literature directly? Must it be presented through expert witness testimony? Are historical comparisons a reasonable predictor of the future?

8. While the foregoing list of issues is lengthy, we do not intend to foreclose either party from raising and addressing any other issue it believes is relevant to a consideration of how to address the finding required by Section 9103(1). We encourage the parties to propose alternative approaches.

B. Should the Commission Determine that the Objective Is "Not in the Best Interests of Ratepayers" ?

As noted by the Court, and as our discussion above indicates, "[e]nsuring the objectives with the certainty required by section 9103 is no easy task." The Court also said the Commission could exercise the option provided by the introductory paragraph to Section 9103 to find that the "objective" of ensuring that local rates were a no higher under an AFOR than under ROR "not in the best interests of ratepayers." The Court stated:

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[12] This raises the interesting question of what action the Commission should take if it were to conclude that rates might be lower for the next five years under a reversion to rate of return regulation with a newly set starting point than under an extension of an existing AFOR without a reset starting point, but that, because ROR regulation would eliminate the incentive for greater efficiency, rates for the longer term would likely be higher. Would the Commission have the authority to reject the shorter-term gain in favor of the longer-term benefit? If not, we could be faced with the paradoxical result that the success of an AFOR in driving down a utility's costs could be the cause of the AFOR's termination.

> The Commission, however, may finally conclude that it cannot make the ensurance required by section 9103(1), regardless of what kind of investigation it conducts, and further conclude that it is better to proceed with the AFOR without fully complying with the literal language of section 9103(1). If so, section 9103 allows the Commission to adopt an AFOR if it "specifically finds that [full technical compliance with section 9103(1) is] not in the best interests of ratepayers," and reports those findings to the legislature in its annual report on the AFOR. 35-A M.R.S.A. § 9103 (sic; correct citation is section 9105).[13]

The possibility discussed by the Court generates questions the parties should address in their comments.

1. Should the Commission find that it is not possible, with the kind of certainty required by the statute, to make the kind of finding concerning two alternative futures that is necessary to meet the first objective under Section 9103, and that the attempt to make such a finding is not in the best interests of ratepayers because such a purported finding can never provide the degree of assurance required by the statute, as interpreted by the Court?

2. Should the Commission consider making any alternative findings, such as that the theoretical basis for incentive regulation is strong, the deficiencies of ROR have been demonstrated over a long period, and the fact that most states have abandoned ROR in favor of incentive regulation provides some assurance that, at the least, incentive regulation does not result in higher local (or local and toll combined) rates? If so, what kind of evidence would the Commission rely on to make this finding?

Accordingly, we

PROVIDE NOTICE

1. That we initiate further proceedings in this case following the vacation, by the Supreme Judicial Court sitting as the Law Court, of the Commission's Order of June 25,

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[13] We do not read Sections 9103 and 9105 together to create a specific requirement that, if the Commission makes the specific finding permitted by Section 9103, it must report that finding to the Legislature. Section 9103 permits the Commission to make the finding and makes no mention of the Legislature. Section 9105 separately requires the Commission to present an annual report to the Legislature, but does not dictate any particular content. Nevertheless, a finding by the Commission that ensuring one of objectives contained in Section 9103 is not possible and not in the interests of ratepayers is a significant event and one that we would report to the Legislature in our annual report both because of the Court's directive and because we would do so anyway.

2001, and remand to the Commission for further proceedings consistent with the Court's opinion;

2. That parties may file comments addressing the issues and questions stated in this Notice. The Hearing Examiner shall establish a schedule for those comments.

Dated at Augusta, Maine, this 19th day of March, 2003.

BY ORDER OF THE COMMISSION

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Dennis L. Keschl
Administrative Director

COMMISSIONERS VOTING FOR: Welch
Nugent
Diamond